February 4, 1994

Short-run policy
Donald L. Kohn

The decision facing the Committee at this meeting with regard to its immediate policy options would seem to be whether a firming of reserve market conditions should occur now, or can be safely and appropriately put off. In the staff forecast, as Mike discussed, it is delayed until the second half of the year. Aggregate demand underlying that forecast is not so strong or the amount of slack so small that postponing the beginning of the rise in rates deflects the core inflation rate from a slight downward trend. A willingness to accept inflation at its current rate, rather than keeping it moving lower, would correspondingly further reduce the urgency for raising rates at this time.

The "wait and see" policy of alternative B also would allow the Committee to better assess the extent to which the recent strength in demand seems likely to persist in the new year--an evaluation a number of you thought important at the last Committee meeting, but one that is complicated in the near term by the effects of the quake and severe weather. Over the balance of the year, the economy may well slow considerably and inflation potential remain damped without Federal Reserve action, as tax increases take effect, key foreign economies founder, and additions to household stocks of durables and houses moderate. Moreover, the market has done some tightening on its own; the rise in long-term interest rates and exchange rates since last fall should damp demand in the quarters ahead. To be sure, these increases will tend to reverse, at least in real terms, if they are not validated at some point by rising short-term rates. Still, some delay is not likely to have a major effect on the degree of restraint, especially if markets continue to expect the Federal Reserve to firm.

However, if the Committee desired a more definite downward tilt to inflation than in the staff forecast, or saw the risks on output, inflation, and inflation expectations as tilted to the up side, firming at this time would seem appropriate.

The proximity of the economy to its potential does increase the danger that even moderate unexpected strength in aggregate demand would feed through over time to an unacceptable increase in inflation pressures. In this situation, real short-term rates would seem quite low, and the Committee has already expressed its view that these rates must be raised at some point to contain inflation. Given the lags, tightening might need to begin fairly soon to avoid difficulties in 1995 and beyond. Both the Committee and the staff foresee a pickup in nominal GDP growth in 1994 relative to 1993. Leaning against this tendency might be seen as consistent with the Committee's longer-run objectives.

Tightening ahead of any deterioration in inflation expectations could have salutary effects on capital markets. Such expectations may not have picked up appreciably yet, at least judging from the most recent evidence in direct surveys of price expectations or in outside economists' forecasts of inflation, and the dollar has remained firm in foreign exchange markets. But there is some risk that they could if the Federal Reserve postponed its action very long, in light of recent data on activity and commodity prices. A sense that inaction was motivated by factors unrelated to the conduct of monetary policy would be especially damaging. An increase in the federal funds rate is widely anticipated--even if the dating is in question. Delay risks raising questions about our priorities and necessitating more drastic action later. A modest rise in the federal funds rate would have small effects on the economy, but would remind the markets that the Fed is still on the job.

As usual, growth of money and credit is of only limited use in guiding the Committee's decision. Broad money growth remains weak--albeit not quite as weak as early last year. The staff has forecast growth of 2 percent on average in M2 over coming months and 1-1/4 percent in M3. Both aggregates would be in the lower halves of their provisional ranges. Borrowing by private sectors, on the other hand, strengthened significantly in the second half of the year, suggesting that the balance sheet constraints on borrowers and lenders have been ebbing rapidly. We expect growth in private debt to continue at this more rapid pace, but not to pick up significantly further.

February 4, 1994

Long-run Policies
Donald L. Kohn

As background for the Committee's discussion of longer-run policy objectives that might be presented in the report to Congress, and of the annual ranges for money and credit, the staff presented in the bluebook a number of long-run scenarios for monetary policy. Given the limitations of economic forecasts in general, the projections obviously shouldn't be taken too seriously. But we think that the simulations may expand on the Greenbook forecast in ways that are useful in the context of your consideration of longer-range strategy.

The first set of simulations gives three possible strategies for policy in terms of the Committee's emphasis on moving to full employment or price stability. The results are found on the table on page 8 and the chart on the following page. One important point is evident from the chart--all three scenarios start from the premise that real short-term interest rates need to rise from current levels to prevent prices from accelerating. In the models, long-term interest rates and exchange rates are the key financial variables driving the economy, but short-term rates are the instrument through which the Federal Reserve influences these variables. The monetary policies associated with the strategies vary by when and how much short-term rates are raised.

You will note that the differences among the alternatives--in terms of the outcomes or the interest rates needed to get them--are not large. For the most part, this reflects the fact that the economy currently is not far from both full employment and price stability. The baseline strategy makes some progress toward full employment and price stability, but doesn't get to either objective. Full employment can be achieved fairly promptly, however, by keeping the federal funds rate at the current level for only a little longer; alternatively, price stability can be approached by moving the funds rate up by the same amount as in the baseline, but sooner and less gradually. In the out years, policy in the latter two alternatives must be calibrated to avoid overshooting in one or the other direction. On one side, overstaying an accommodative policy could quickly push the economy past its potential and give an upward nudge to inflation; avoiding this possibility requires a fairly sharp rise in short-term rates beginning in 1995 in the easy strategy--to a level in nominal terms above that for the other two strategies. On the other side, an aggressive policy of pushing up nominal rates to approach price stability within the period of the simulation risks arriving at this ultimate objective with an unemployment rate that implies future deflation; avoiding this outcome dictates a drop in rates mid-way through the period in the tighter strategy.

Charts 2 and 3 look at the implications of some potential risks to the outlook. These exercises make two types of points. First, they show the importance of some key assumptions in shaping the staff projections. And second, they illustrate the difficulties for monetary policy caused by lags in the response of policy to changed circumstances and by lags in the response of the economy to policy actions. Chart 2 following page 10 addresses the possibility that the NAIRU is 1/2 percentage point higher or lower than assumed in the baseline. If it is higher, a possibility raised by recent compensation data, the economy is already operating beyond its potential. In this circumstance, even the rapid and pronounced tightening, shown by the dashed line, which is delayed a bit until the problem becomes apparent, can't avoid some small pickup in inflation in the near term.

levels assumed in the baseline. Even so, the excess or shortfall in aggregate demand feeds through quickly to labor and product markets, whereas the influence of an alert and prompt monetary policy response is only felt some quarters later. Thus, even fairly rapid and robust responses do not avoid rising unemployment in the weak demand case or more rapid inflation in the strong demand case.

In constructing the money growth paths for each strategy, we took account of movements in both short-term and long-term rates, as well as the behavior of nominal spending. In addition, we assumed that some of the unusual intermediation patterns of recent years would persist--but that they would fade out over time as loan demands at depositories picked up and as savers became better adjusted to the availability of mutual funds and to their greater inherent riskiness relative to deposits.

These factors informed our projections of money and credit for 1994 and 1995, shown on page 13. We expect debt growth about in line with nominal GDP again in 1994. More comfortable balance sheets and greater credit availability lead to a pickup in borrowing by sectors other than governments. In the total, this is about offset by a drop in federal borrowing, owing to the effects of deficit reduction